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2016

The Advantages of the Current Middle Ground Approach to Corporate Scierter and the Need for a Better Standard

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Recommended Citation

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INTRODUCTION

The Private Securities Litigation Reform Act of 1995 (“PSLRA”),¹ created heightened pleading standards in securities-fraud cases.² To satisfy this heavier burden, plaintiffs must identify each misleading or false statement and explain how each statement is misleading.³ In addition, plaintiffs must “state with particularity facts giving rise to a strong inference that the defendant[s] acted with the required state of mind.”⁴ This standard is often difficult to satisfy as it is challenging to produce evidence that demonstrates an individual had the requisite scienter.⁵

However, the heightened standard for pleading scienter in securities fraud cases can be even more complicated when considering a defendant that is a corporation “because there is the additional question of whose knowledge and state of mind matters.”⁶ The Sixth Circuit properly referred to the PSLRA as an “elephant-sized boulder blocking” a plaintiff’s suit as these requirements are not easily satisfied.⁷ “This is especially so considering, for example, in the context of a forward-looking statement, that the plaintiff must ‘prove that [a] forward-looking statement . . . was made with actual knowledge’ to prevail, a formidable burden at the pleading stage.”⁸ The question at hand is must the person misrepresenting a material fact in the name of the corporation have also done so with scienter, or is it enough that some person in the corporate structure had the requisite state of mind.⁹

¹ Pub. L. No. 104-67, 109 Stat. 737, codified at 15 U.S.C. § 78u-4.

² *Id.*

³ 15 U.S.C. § 78u-4(b)(1)(B).

⁴ 15 U.S.C. § 78u-4(b)(2)(A).

⁵ *KBC Asset Mgmt. N.V. v. Omnicare, Inc. (In re Omnicare, Inc. Sec. Litig.)*, 769 F.3d 455, 461 (6th Cir. 2014).

⁶ *Id.* at 469.

⁷ *Id.* at 461.

⁸ 15 U.S.C. § 78u-5(c)(1)(B); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 554 (6th Cir. 2001).

⁹ *In re Omnicare*, 769 F.3d at 473.

In dealing with the issues raised by corporate scienter, the Third, Fifth, and Eleventh Circuits in varying degrees have adopted the view that scienter may be imputed to the corporation only where the person who made the alleged misstatement attributable to the company made the statement with knowledge of its falsity.¹⁰ On the other end of the spectrum, other the Second, Seventh, and Ninth Circuit courts, have advocated with some variations that plaintiffs may meet their pleading burden by alleging facts creating a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter, even if that person is not a named defendant.¹¹ In the most broad interpretation, the Sixth Circuit previously found that the plaintiffs adequately alleged that an officer of the corporate defendant was aware that the statements at issue were false or misleading and held that the officer's knowledge could be attributed to the corporation even though the complaint did not link the executive to the issuance of the statements.¹²

However, the Sixth Circuit's current approach in *Omnicare* is an attempt to create a middle ground standard in this spectrum of corporate scienter pleading requirement cases.¹³ In its most recent decision, the Sixth Circuit advanced the position that the state(s) of mind of the individual agent who uttered or issued the misrepresentation; or an individual agent who authorized, requested, commanded, furnished information for, prepared, reviewed, or approved the statement in which the misrepresentation was made before its utterance or issuance, or any

¹⁰ Joseph M. McLaughlin, *Pleading Corporate Scienter: Circuits Split on Standard*, 252 N.Y.L.J. 5, (2014) (referring to *Southland Sec. Corp. v. INSpire Ins. Solutions*, 365 F.3d 353, 366 (5th Cir. 2004); *In re Tyson Foods*, 155 Fed. Appx. 53, 57 (3d Cir. 2005); *Phillips v. Scientific-Atlanta*, 374 F.3d 1015, 1018 (11th Cir. 2004)).

¹¹ *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 710 (7th Cir. 2008); *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital, Inc.*, 531 F.3d 190, 196 (2d Cir. 2008).

¹² *City of Monroe Emples. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 688-89 (6th Cir. 2005)

¹³ *In re Omnicare*, 769 F.3d at 476.

high managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated the misrepresentation after its utterance or issuance are probative for determining whether a misrepresentation made by a corporation was made with the requisite intent.¹⁴

Congress designed the PSLRA to curb perceived abuses of the private action—“nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers.”¹⁵ As such, securities fraud cases require a deviation from the normally uniform pleading standards.¹⁶ This deviation evidences the unique nature of securities fraud actions and the delicate balance a court must strike when considering them.¹⁷

On one hand, a court must weigh the important public interests in protecting shareholders from the fraudulent conduct of corporate officers and directors, and in providing purchasers with a remedy for injuries related to such conduct.¹⁸ On the other hand, a court must consider an equally important interest in protecting corporations from baseless strike suits filed by opportunists looking to make a quick buck.¹⁹ Faced with the prospect of expensive discovery, reputational damage, and a potentially enormous damages award, corporate defendants have a great incentive to settle even non-meritorious cases.²⁰

In this article, I will first give a background on securities fraud statutes generally. Then I will proceed to discuss scienter and go through an analysis of each circuit’s interpretation of scienter. After which, I will discuss the new middle ground standard for scienter and its implications and advantages. Finally, I will address how the new standard is not necessarily in

¹⁴ *Id.*

¹⁵ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 320 (U.S. 2007).

¹⁶ Erica E. Bonnet, Note, *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc.*, 54 N.Y.L. SCH. L. REV. 395, 396 (2010).

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

the middle of the spectrum for scienter but rather leaning towards the narrow interpretation of scienter. Lastly, I will focus on the need of an actual middle ground approach that strikes the correct balance between the narrow and broad scienter approaches.

BACKGROUND

In order to pursue a securities fraud action under the PSLRA, a plaintiff must allege that the defendant made misleading statements and omissions in reference to an untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.²¹ The plaintiff's complaint must specifically allege each misleading statement, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.²² After which, the requisite state of mind, scienter, is then considered.²³ In general, in any private action in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.²⁴

²¹ 15 USCS § 78u-4(b)(1).

²² *Id.*

²³ 15 USCS § 78u-4(b)(2).

²⁴ *Id.* (The exception is the case of an action for money damages brought against a credit rating agency or a controlling person under 15 USCS §§ 78a et seq., it shall be sufficient, for purposes of pleading any required state of mind in relation to such action, that the complaint state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to either conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or to obtain reasonable verification of such factual elements from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.)

Similarly under § 10(b) of the 1934 Act and SEC Rule 10b-5, There are six elements to a securities-fraud suit: “(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.”²⁵

The focus of this comment, “scienter,” is “a mental state embracing intent to deceive, manipulate, or defraud.”²⁶ Section 10(b) forbids a company or an individual “to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.”²⁷ Under the PSLRA and Section 10(b), a plaintiff must allege that a defendant possessed scienter at the time of the material misstatement or omission.²⁸

There is difficulty, however, ascertaining whether a corporation has the requisite scienter. When the defendant is a corporate entity—with no single mind of its own—whose state of mind matters for purposes of the scienter analysis?²⁹ As the Sixth Circuit recently asked in *In re Omnicare, Inc. Sec. Litig.*, “must the person misrepresenting a material fact in the name of the corporation have also done so with scienter, or is it enough that some person in the corporate structure had the requisite state of mind?”³⁰ In response, the Sixth Circuit formulated a “middle ground” approach, combining elements of the restrictive and liberal tests previously adopted by

²⁵ KBC Asset Mgmt. N.V. v. Omnicare, Inc. (In re Omnicare, Inc. Sec. Litig.), 769 F.3d 455, 469 (6th Cir. 2014) (citing *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1317 (2011) (internal quotation marks omitted)).

²⁶ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 n.12 (1976).

²⁷ 17 C.F.R. § 240.10b-5(b).

²⁸ See *Ernst & Ernst*, 425 U.S. at 197.

²⁹ *McLaughlin*, *supra* note 10, at 5.

³⁰ *Id.*

other courts of appeal over the last decade and adding its view to the existing circuit split on the issue.³¹

To ensure the scienter requirement was properly met in the PSLRA, Congress required that the state of mind of the defendant must be connected to the act of deception: “[I]n any private action arising under [the PSLRA] in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”³²

As scienter relates to fraud, it must comply the standards of Rule 9(b).³³ Federal Rule of Civil Procedure 9(b) requires the plaintiffs in securities fraud causes to plead with particularity the circumstances constituting the alleged fraud.³⁴ To satisfy Rule 9(b)'s pleading requirements, the plaintiffs must “specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent.”³⁵ In securities fraud cases, a heightened pleading standard provides defendants with “fair notice of the plaintiffs' claims, protects defendants from harm to their reputation and goodwill, reduces the number of strike suits, and prevents plaintiffs from filing baseless claims and then attempting to discover unknown wrongs.”³⁶ The PSLRA reinforces the particularity requirements of Rule 9(b), requiring the plaintiffs to state not only the time, place, the identity of

³¹ Id.

³² 15 U.S.C. § 78u-4(b)(2)(A)

³³ Fed. R. Civ. P. 9(b)

³⁴ Id.

³⁵ *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 362 (5th Cir. 2004) (quoting *Williams v. WMX Technologies, Inc.*, 112 F.3d 175, 177-78 (5th Cir. 1997)).

³⁶ Id. at 363. (quoting *Tuchman v. DSC Communications*, 14 F.3d 1061, 1067 (5th Cir. 1994)).

the speaker, and the content of the alleged misrepresentation, but also to explain why the challenged statement or omission is false or misleading.³⁷

What constitutes the scienter element in a securities suit remains a question of law by the federal circuit courts although the United States Supreme Court created a three-part test for lower courts to apply in assessing the sufficiency of a plaintiff's scienter allegations.³⁸ In this test, a court must first “accept all factual allegations in the complaint as true.”³⁹ Second, a court “must consider the complaint in its entirety” and decide “whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.”⁴⁰ Third, assuming that plaintiff's allegations create a “powerful or cogent” inference of scienter, a court must compare this inference with other competing possibilities, allowing the complaint to go forward “only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”⁴¹

When the defendant is an individual, the court examines the facts and “applies this test ... considering the *Helwig* factors such as whether there was: (1) insider trading at a suspicious time or in an unusual amount; (2) divergence between internal reports and external statements on the same subject; (3) closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information; (4) evidence of bribery by a top company official; (5) existence of an ancillary lawsuit charging fraud by a company and the company's quick settlement of that suit; (6) disregard of the most current factual information before making

³⁷ Id. at 363 (quoting *Williams*, 112 F.3d at 177).

³⁸ *In re Omnicare*, 769 F.3d at 473. (quoting *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322-23 (2007)).

³⁹ Id.

⁴⁰ Id.

⁴¹ Id.

statements; (7) disclosure of accounting information in such a way that its negative implications could only be understood by someone with a high degree of sophistication; (8) the personal interest of certain directors in not informing disinterested directors of an impending sale of stock; and (9) the self-interested motivation of defendants in the form of saving their salaries or jobs.⁴² A stronger inference that the defendant made her statement with the requisite state of mind can be drawn when a greater number of these factors are present.⁴³

Determining scienter becomes more complicated when the defendant is a corporation because there is the additional question of whose knowledge and state of mind matters.⁴⁴ In scienter cases, there are often “two competing inferences (always assuming of course that the plaintiffs are able to prove the allegations of the complaint).”⁴⁵ One inference is the company knew or was reckless in failing to realize, that the statements were false, which is material to investors.⁴⁶ The other inference is that although the statements were false and material, their falsity was the result of innocent, or at worst careless, mistakes at the executive level.⁴⁷ For example, “[s]uppose a clerical worker in the company's finance department accidentally overstated the company's earnings and the erroneous figure got reported in good faith up the line to...senior management, who then included the figure in their public announcements.”⁴⁸ Even if senior management failed to detect the error, there would be no corporate scienter.⁴⁹ For liability to attach to the corporation, must the person misrepresenting a material fact in the name of the

⁴² *In re Omnicare*, 769 F.3d at 473 (quoting *Helwig v. Vencor, Inc.*, 251 F.3d 540, 552.(6th Cir. 2001)).

⁴³ *In re Omnicare*, 769 F.3d at, 473.

⁴⁴ *Id.*

⁴⁵ *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 707 (7th Cir. 2008)

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

corporation have also done so with scienter, or is it enough that some person in the corporate structure had the requisite state of mind.⁵⁰ If the latter conception is correct, how high in the hierarchy of the corporation must the person with scienter be located, and what must his relationship be to the statement? The Circuit Courts of Appeals are divided on these questions.⁵¹

A. Narrow Interpretation of Corporate Scienter: *Respondeat Superior* Approach

Some courts have adopted the view that scienter may be imputed to the corporation only where the person who made the alleged misstatement attributable to the company in fact made the statement with knowledge of its falsity.⁵² In 2004, the Fifth and Eleventh Circuits adopted a narrow view to corporate scienter in tandem with common-law-fraud principles, allowing scienter to be imputed to the corporation only under a theory of *respondeat superior*.⁵³ These circuits “look[ed] to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like) rather than generally to the collective knowledge of all of the corporation's officers and employees acquired in the course of their employment.”⁵⁴

The Fifth Circuit reasoned that the PSLRA requires the plaintiffs to distinguish among those they sue and enlighten *each defendant* as to his or her particular part in the alleged fraud.⁵⁵

As such, corporate officers may not be held responsible for unattributed corporate statements

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² Joseph M. McLaughlin, *Pleading Corporate Scienter: Circuits Split on Standard*, 252 N.Y.L.J. 5, (2014) (referring to *Southland Sec. Corp. v. INSpire Ins. Solutions*, 365 F.3d 353, 366 (5th Cir. 2004); *In re Tyson Foods*, 155 Fed. Appx. 53, 57 (3d Cir. 2005); *Phillips v. Scientific-Atlanta*, 374 F.3d 1015, 1018 (11th Cir. 2004)).

⁵³ *In re Omnicare*, 769 F.3d at 473.

⁵⁴ *Southland Sec. Corp. v. Inspire Ins. Solutions, Inc.*, 365 F.3d 353, 366 (5th Cir. 2004)

⁵⁵ *Id.* at 365.

solely on the basis of their titles, even if their general level of day-to-day involvement in the corporation's affairs is pleaded.⁵⁶ “Liability [for scienter] requires...that the party make a statement...with ‘scienter’ meaning an ‘intent to deceive, manipulate, or defraud’ or that ‘severe recklessness’ in which the ‘danger of misleading buyers or sellers . . . is either known to the defendant or is so obvious that the defendant must have been aware of it.’”⁵⁷

To determine whether a statement made by the corporation was made by it with the requisite scienter, “the state of mind of the individual corporate official or officials who make[s] or issue[s] the statement (or order[s] or approve[s] it or its making or issuance, or who furnish[es] information or language for inclusion therein, or the like) rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment.”⁵⁸ “A defendant corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter, i.e., knows that the statement is false, or is at least deliberately reckless as to its falsity, at the time he or she makes the statement.”⁵⁹ This is consistent with the general common law rule that for example, in the case of fraud, an essentially subjective state of mind is an element of a cause of action also involving some sort of conduct, such as a misrepresentation, where the required state of mind must actually exist in the individual making (or be a cause of the making of) the misrepresentation, and may not simply be imputed to that individual on general principles of agency.⁶⁰ Accordingly, for purposes of evaluating whether the complaint states with particularity facts giving rise to a strong inference that determines “where a party had the requisite

⁵⁶ *Id.*

⁵⁷ *Id.* at 365 (quoting *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc)).

⁵⁸ *Southland*, 365 F.3d at 365-366.

⁵⁹ *Id.*

⁶⁰ *Id.* 366-367. (quoting Restatement (2nd), Agency § 275, comment b; § 268 comment d.)

scienter...it is only necessary...to address the allegations claimed to adequately show such state of mind on the part of the individual defendants.”⁶¹ The Eleventh Circuit echoed the Fifth Circuit’s decision in *Southland in Phillips v. Scientific-Atlanta Inc.*⁶² Similarly, the Third Circuit ruled that an individual defendant who made allegedly misleading statements did not act with the requisite state of mind, and it therefore concluded that the corporate defendant could not be held liable.⁶³

B. Broader Interpretation of Corporate Scienter

1. Seventh Circuit Approach

The Seventh Circuit recognized that “it is possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud.”⁶⁴ The court reasoned through a hypothetical: “Suppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero.”⁶⁵ There would be a strong inference of corporate scienter, since corporate officials who were sufficiently knowledgeable about the company would have approved such a dramatic announcement.⁶⁶ Because these officials possess this knowledge, they should know that the announcement was in fact false.⁶⁷ In that case however, the Seventh Circuit did not have to rely upon an expansive view of collective corporate scienter because the court held that the plaintiffs adequately pleaded that the CEO

⁶¹ *Id.*

⁶² See *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015 (11th Cir. 2004)

⁶³ *In re Tyson Foods*, 155 Fed. Appx. 53, 57 (3d Cir. 2005).

⁶⁴ *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 710 (7th Cir. 2008).

⁶⁵ *Id.* at 711.

⁶⁶ *Id.*

⁶⁷ *Id.*

knowingly misrepresented material facts with the intent to defraud and that his individual liability could be imputed to the corporation.⁶⁸

2. Second Circuit Approach

Somewhat similarly, the Second Circuit agreed that plaintiffs could plead collective corporate scienter, at least in some cases, and overcome the PSLRA's requirements.⁶⁹ The court stated: “[it] do[es] not believe that [Congress] imposed the rule . . . that in no case can corporate scienter be pleaded in the absence of successfully pleading scienter as to an expressly named officer.”⁷⁰ “When the defendant is a corporate entity...the pleaded facts must create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter.”⁷¹ The court reasoned that in most cases, the most straightforward way to raise an inference for a corporate defendant was to plead it for an individual defendant but it is also possible to raise the required inference to a corporate defendant without identifying an individual officer or employee.⁷²

3. Ninth Circuit Approach

Finally, the Ninth Circuit also added to this position in the spectrum of cases, stating that it “had at that time not categorically rejected the concept of ‘collective scienter’” and that “there could be circumstances in which a company's public statements were so important and so dramatically false that they would create a strong inference that at least some corporate officials

⁶⁸ *Id.*

⁶⁹ *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 196 (2d Cir. 2008).

⁷⁰ *Id.*

⁷¹ *Teamsters*, 531 F.3d at 195.

⁷² *Id.*

knew of the falsity upon publication.”⁷³ The Ninth Circuit reaffirmed its previous holding in *Janas v. McCracken (In re Silicon Graphics Inc. Securities Litigation)*, stating that “plaintiffs proceeding under the PSLRA can no longer claim intent in general terms of mere ‘motive’ and ‘opportunity’ or ‘recklessness,’ but rather, must state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent.”⁷⁴ Yet, importantly, the Ninth Circuit clarified its previous holding in *Nordstrom*, stating that it “does not foreclose the possibility that, in certain circumstances, some form of collective scienter pleading might be appropriate.”⁷⁵

C. Broadest Interpretation of Corporate Scienter: Earlier Sixth Circuit Approach in 2005

Previously, the Sixth Circuit employed the most lenient scienter standard out of all the circuit courts of appeal. The standard allowed the court to impute the knowledge of a corporate officer to the corporation even though that officer did not issue the false or misleading statement.⁷⁶ For example, in *City of Monroe*, the plaintiffs alleged that the corporation made several material misrepresentations in its annual report, and the court held that these statements were actionable.⁷⁷ Plaintiffs also alleged that the CEO had actual knowledge that these statements were false or misleading, and the court held that this knowledge could be attributed to the corporation, even though the complaint failed to link the CEO to the issuance of the statements.⁷⁸ Ultimately, the Sixth Circuit “employed a totality of the circumstances analysis [in its scienter analysis] whereby the facts argued collectively must give rise to a strong inference of

⁷³ *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 744 (9th Cir. 2008) (internal citations omitted).

⁷⁴ *Id.* at 743 (quoting *Janas v. McCracken (In re Silicon Graphics Inc. Securities Litigation)* quoting 183 F.3d 970, 979 (9th Cir. 1999)).

⁷⁵ *Id.*

⁷⁶ *City of Monroe Emples. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683 (6th Cir.. 2005)

⁷⁷ *Id.* at 680-81.

⁷⁸ *Id.* at 688-89.

at least recklessness.”⁷⁹ Furthermore, in its reasoning, the court identified at least five of the nine *Helwig* factors that are apparent in the complaint's alleged facts.⁸⁰ First, there was a clear “divergence between internal reports and external statements on the same subject.”⁸¹ There was also a “closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information” as well as a “disregard,” or at least a seeming disregard, of “the most current factual information before making statements.”⁸² As a result, the Sixth Circuit decided that the plaintiffs' suit could go forward against the corporation, concluding that the scienter requirement was properly met.⁸³

D. The Middle Ground Approach to Corporate Scienter: *KBC Asset Mgmt. N.V. v. Omnicare, Inc.* – Current Sixth Circuit Approach

1. Factual Background

The plaintiff claimed that the defendant corporation's Form 10-Ks from 2007 to 2010 contained material misrepresentations because they stated that “[Omnicare] believe[s] that [its] billing practices materially comply with applicable state and federal requirements” and that “[defendant corporation] believe[s] that [it is] in compliance in all material respects with federal, state and local laws.”⁸⁴ The Complaint also stated specifically which of the defendant corporation's officers signed these misleading forms.⁸⁵ The issue here is that defendant

⁷⁹ *City of Monroe*, 399 F.3d at 683 (quoting *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 683 (6th Cir. 2004)).

⁸⁰ *PR Diamonds*, 364 F.3d at 684 (quoting *Helwig*, 251 F.3d at 551).

⁸¹ *City of Monroe*, 399 F.3d at 683.

⁸² *Id.*

⁸³ *Id.* at 689.

⁸⁴ *KBC Asset Mgmt. N.V. v. Omnicare, Inc. (In re Omnicare, Inc. Sec. Litig.)*, 769 F.3d 455, 464 (6th Cir. 2014)

⁸⁵ *Id.*

corporation received unfavorable audit results when it conducted three audits of its practices.⁸⁶ The plaintiffs further claimed that the defendant corporation failed in its duty to disclose the audit results once it knew of them, creating an actionable omission.⁸⁷

With respect to scienter, plaintiffs alleged that each of the defendants knew that their statements and those of the company, which they personally prepared, were false and misleading.⁸⁸ Plaintiffs further stated that the defendants here were privy to confidential information that they had a duty to disclose, and by choosing not to do so, they acted with the requisite intent to defraud.⁸⁹ According to the plaintiffs, the personal acquisition of wealth drove the individual defendants to commit fraud, and the defendants purportedly amassed wealth by permitting fraudulent Medicare and Medicaid reimbursements, which allegedly accounted for more than half of Omnicare's business during the class period.⁹⁰

2. Current Sixth Circuit Standard

To resolve the issue presented in the *KBC Asset Mgmt. N.V. v. Omnicare, Inc.*, the Sixth Circuit created a middle ground approach to scienter.⁹¹ Under this approach, the state(s) of mind of any of the following people are probative for purposes of determining whether a misrepresentation made by a corporation has the requisite scienter under Section 10(b):

“(a) The individual agent who uttered or issued the misrepresentation; (b) Any individual agent who authorized, requested, commanded, furnished information for, prepared (including suggesting or contributing language for inclusion therein or omission therefrom), reviewed, or approved the statement in which the misrepresentation was made before its utterance or issuance; (c) Any high

⁸⁶ Id.

⁸⁷ Id.

⁸⁸ Id.

⁸⁹ Id.

⁹⁰ Id. at 464.

⁹¹ Id. at 476.

managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated the misrepresentation after its utterance or issuance.”⁹²

This new standard is the Sixth Circuit’s attempt to bridge the gap in the spectrum of scienter interpretations pertaining to securities fraud cases.⁹³

ARGUMENT

A. Is this new standard really an improvement?

The new standard is better than what courts have routinely used. Although the old standard was a more formalistic, rule driven approach, it did not fully cater to the public policy driven broad interpretation of scienter. Yet, the middle ground approach appears to be more of an upper middle ground approach rather than a true middle ground approach that strikes a harmonious balance between the two ends of the scienter spectrum. The standard still leans towards an ultra-heightened pleading standard, one which supporters of the narrow scienter approach desire.

B. Advantages of the New Sixth Circuit Approach Over the other Circuit Approaches

This middle ground approach still aligns with the Sixth Circuit’s early ruling on scienter.⁹⁴ The Sixth Circuit reconciled its previous decision in *City of Monroe*, stating that its current findings were consistent its previous decision although it qualifies some of that opinion’s overly broad language.⁹⁵ While some of the language in *City of Monroe* suggests that the knowledge of any agent of the company could be imputed to the corporation, the court relied on the CEO’s knowledge, a person included in Part C of the new standard.⁹⁶ The Sixth Circuit determined that the broader language of the *City of Monroe* decision is not necessary to arrive at

⁹² Id. at 476.

⁹³ Id. at 477.

⁹⁴ Id.

⁹⁵ Id. at 477.

⁹⁶ Id; see also *City of Monroe*, 399 F.3d at 688.

that panel's conclusion and is thus, dicta.⁹⁷ Moreover, the result of *City of Monroe* would not change under the clarification of the new standard because the CEO's knowledge would still be imputed to the corporation.⁹⁸

Also, this new rule “largely prevents corporations from evading liability through “tacit encouragement and willful ignorance, as they potentially could under a strict *respondeat superior* approach.”⁹⁹ Where there is no identifiable culpable actor, the *respondeat superior* approach could allow corporations that condone illegal activity the opportunity to escape liability.¹⁰⁰ Such an approach could incentivize companies inclined to commit fraud to isolate the individuals speaking on the company's behalf from any facts that may contradict their public statements.¹⁰¹ Under the new rule, however, a “corporation is not insulated if lower-level employees, contributing to the misstatement, knowingly provide false information to their superiors with the intent to defraud the public.”¹⁰² As a result, corporations that willfully permit or encourage the shielding of bad news from management will potentially be liable and therefore, the purpose of the 1934 Act will be served.¹⁰³

Additionally, the new rule protects corporations from liability or strike suits when one individual unknowingly makes a false statement that another individual, unrelated to the preparation or issuance of the statement, knew to be false or misleading.¹⁰⁴ By allowing courts to examine only the states of mind of lower-level employees connected to the statements, the

⁹⁷ *Id.*

⁹⁸ *In Re Omnicare*, 769 F.3d at 476-477.

⁹⁹ *Id.* at 477.

¹⁰⁰ *Id.* at 476.

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

new rule “prevents plaintiffs from abusing the broad dicta in *City of Monroe* and running afoul of the PSLRA.”¹⁰⁵

While a broader view of collective corporate scienter would most likely discourage managers of companies from deliberately separating the employees making public statements with knowledge of the company's transgressions from those employees who do not know,¹⁰⁶ the Sixth Circuit acknowledged that a more expansive approach “could expose corporations to liability far beyond what Congress has authorized.”¹⁰⁷ The problem with inferring a collective intent to deceive behind the act of a corporation is that the hierarchical corporate structure makes it plausible that fraud, though ordinarily a deliberate act, could be the result of a series of acts none of which was both done with scienter and imputable to the company through the *respondeat superior* doctrine.¹⁰⁸ Someone low in the corporate hierarchy might make a mistake that formed the premise of a statement made at the executive level by someone who was at worst, careless in having failed to catch the mistake.¹⁰⁹ Applying the *respondeat superior* approach to such an example would impute a scienter to the corporation that none of its employees or directors had in the first place.¹¹⁰

Also, the “group pleading doctrine conflicts with the scienter requirement of the PSLRA” because “the PSLRA requires . . . plaintiffs to distinguish among those they sue and enlighten *each defendant* as to his or her particular part in the alleged fraud.”¹¹¹

¹⁰⁵ *Id.*

¹⁰⁶ Joseph M. McLaughlin, *Pleading Corporate Scienter: Circuits Split on Standard*, 252 N.Y.L.J. 5, (2014)

¹⁰⁷ *In Re Omnicare*, 769 F.3d at 476-77.

¹⁰⁸ *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 707 (7th Cir. 2008).

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 744 (9th Cir.. 2008)(quoting *Southland Securities Corp. v. INSpire Insurance Solutions Inc.*, 365 F.3d 353, 363-64 (5th Cir. 2004)).

The PSLRA raised the pleading requirements for scienter in an attempt to discourage frivolous securities litigation.¹¹² Under the collective scienter approach, plaintiffs are able to pass the motion to dismiss stage too easily.¹¹³ By doing so, plaintiffs now have increased their chances of reaching large settlements with corporate defendants, thereby undermining the purpose of the PSLRA.¹¹⁴

C. The New Middle Ground v. the Old Middle Ground

Previously, the Fifth Circuit's *Southland* approach was titled the semi-strong-form or middle ground approach of corporate scienter.¹¹⁵ In order to prove that a corporate defendant acted with scienter under that approach, a plaintiff must provide evidence showing that an individual agent who is connected to but not necessarily the creator of the misstatement at issue had scienter.¹¹⁶ Regardless of whether a plaintiff has to identify scienter for an individual connected to a corporate misstatement or the creator of the misstatement herself, the plaintiff still faces a challenging burden to satisfy the PSLRA.¹¹⁷ Identifying scienter is no easy task without next to concrete proof as it is often difficult to produce this evidence at the pleading stage of a securities fraud action.¹¹⁸

When compared to the new Sixth Circuit *Omnicare* standard, the Fifth Circuit's approach is far from the middle of the spectrum in determining scienter. The Fifth Circuit's method of specifying scienter to an individual agent is somewhat engulfed in part A of the new middle ground for scienter which allows the state of mind of an individual agent who issued the

¹¹² McLaughlin, *supra* note 105, at 5.

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ Paul B. Maslo, *Evaluating Approaches to Pleading Corporate Scienter: The Case for Semi-Strong Form Corporate Scienter in Securities*, 108 MICH. L. REV. 95, 99 (2011).

¹¹⁶ *Id.*

¹¹⁷ *In Re Omnicare*, 769 F.3d at 461.

¹¹⁸ *Id.*

misrepresentation to be probative for determining whether a misrepresentation made by a corporation was made with the requisite intent.¹¹⁹ Yet, the new standard still has more to offer to a plaintiff through parts B and C. Slanting too far toward the Fifth Circuit's approach risks running counter to the goals and purposes of the 1934 Act, which includes fostering “an attitude of full disclosure by publicly traded corporations, rather than a philosophy of *caveat emptor* for securities buyers.”¹²⁰ Accordingly, the Fifth’s Circuit’s approach is more appropriately part of the narrow approach to scienter.

D. The Middle Ground Reaches a Similar Result as the Narrow Interpretation

The Sixth Circuit claims that there is such a substantial difference between the narrow interpretation and its new middle ground standard.¹²¹ However, when the middle ground approach is applied to a case with a sufficient pleading that did not meet the Fifth Circuit’s narrow approach, the same result is achieved.¹²²

In *Southland*, plaintiffs contended that defendants “engaged in a fraudulent scheme to deceive investors about the company's performance for the purpose of inflating the price of INSpire stock for their own financial benefit.”¹²³ The defendants allegedly committed securities fraud by knowingly, or with severe recklessness, advertising INSpire's software products and contracts despite their knowledge of the flawed software, issuing inaccurate earnings and revenue estimates, and violating Generally Accepted Accounting Principles (“GAAP”) by failing to timely classify receivables as uncollectible, improperly capitalizing software development

¹¹⁹ *In re Omnicare*, 769 F.3d at 476.

¹²⁰ *Id.* at 475 (quoting Heather F. Crow, *Riding the Fence on Collective Scienter: Allowing Plaintiffs to Clear the PSLRA Pleading Hurdle*, 71 La. L. Rev. 313, 317 (2010) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186, 84 S. Ct. 275, 11 L. Ed. 2d 237 (1963))).

¹²¹ *In re Omnicare*, 769 F.3d at 476.

¹²² *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 360 (5th Cir. 2004)

¹²³ *Id.*

costs, and failing to write down goodwill associated with purchases of software assets.¹²⁴ The plaintiffs assert these misleading statements were made in “forward-looking statements, press releases, and other corporate documents, and relied upon by analysts in their reports” and subsequently sold stock based on this information.¹²⁵ The Fifth Circuit did not allow plaintiffs to rely on a presumption that statements in “prospectuses, registration statements, annual reports, press releases, or other group-published information, *are* the collective work of those individuals with direct involvement in the everyday business of the company.”¹²⁶ Even though the top-level officers and directors such as the Treasurer and CFO in this case, certify the accuracy of those documents, the Fifth Circuit did not feel comfortable allowing plaintiffs to use a group pleading doctrine.¹²⁷ The Fifth Circuit reasoned that the plaintiffs’ allegation that the defendants committed fraud by reporting the company’s results for the fourth quarter of 1997 and year end 1997 failed to meet the pleading requirements because the plaintiffs failed to explain how or in what particular way the reported earnings and revenues figures were inaccurate.¹²⁸ Accordingly, the Fifth Circuit determined that the plaintiffs’ conclusory allegation that the defendants knew the figures were false relied on “group pleading” and failed to plead facts with the requisite specificity to generate a strong inference of scienter.¹²⁹

Applying the middle ground approach to the facts ultimately arrives at the same end. Similar to *Omnicare*, the directors in *Southland* published incorrect and misleading information in their financial documents.¹³⁰ Comparable to the Vice President defendant in *Omnicare*, the

¹²⁴ *Id.*

¹²⁵ *Id.* at 362.

¹²⁶ *Id.* at 363.

¹²⁷ *Id.* at 364.

¹²⁸ *Id.*

¹²⁹ *Southland*, 365 F.3d at 370.

¹³⁰ *Southland*, 365 F.3d at 360 (5th Cir. 2004); *In re Omnicare*, 769 F.3d at 483 (6th Cir. 2014).

Treasurer/CFO's knowledge in *Southland* could be imputed to the corporation because he was the officer who certified the corporation's financial documents.¹³¹ Yet as in *Omnicare*, pleading that level of information is not sufficient to suggest a strong inference that the corporate defendant in *Southland* acted to defraud the public and satisfy the middle ground standard.¹³² Even though only a limited number of scenarios could have taken place such as the officer being complicit in the scheme or the officer lacking the competence to determine that there was mistake. However, the either of those two situations paired with the simultaneous coincidence that there was also a significant opportunity to profit should balance the strong interference toward the notion that the corporate defendant did act with requisite scienter to defraud the public.

Even in a case where the most narrow standard is applied and Sixth Circuit's new approach is also applied to the same facts, the same result is still achieved: a plaintiff lacking sufficient pleading for scienter. The set of facts in *Southland* or *Omnicare* are not in the group of outliers as rare factual occurrences that seldom transpire in the business world but rather common issues that corporate defendants face. If the middle ground standard only works sometimes in somewhat ideal factual circumstances, then does it really provide all the benefits that it purports to have?

E. Still Not in the Middle as a Standard

Admittedly, the current Sixth Circuit approach is a more reasonable middle ground when compared to *Southland* and *Bridgestone* on the other end of the spectrum of scienter. However, this new standard is still not at the midpoint of the scienter continuum. The issue is that modern

¹³¹ *Id.*

¹³² *Id.*

corporate structure necessitates the use of a broader form of corporate scienter.¹³³ The Sixth Circuit attempts to reach a broader approach through parts B and C of its new standard articulated in *Omnicare*. Part B considers the state of mind probative for any individual agent of the corporation who authorized, requested, commanded, furnished information for, prepared, reviewed or approved the statement in which the misrepresentation was made before its issuance.¹³⁴ And Part C addresses a managerial agent or board member who ratified, tolerated or recklessly disregarded the misrepresentation after its issuance.¹³⁵ Parts B and C initially appear to cast a broader net in terms of flexibility to find scienter existed but *Omnicare* demonstrates otherwise.

In *Omnicare*, the Sixth Circuit held that the complaint did not sufficiently meet the scienter requirements because of a lack of specificity.¹³⁶ Although the plaintiff identified a defendant officer who presented the misrepresentation, the audit report, which evidenced that pervasive fraud had been underway, and not disclosed to the public to the Omnicare's Internal Audit and Compliance committee, the plaintiff still needed to provide more information to meet the scienter requirement.¹³⁷ Even though, the court concluded that while a reasonable jury could find a divergence between internal reports (the audits) and external statements, there is still an inference that corporations have certain levels of generality at which the internal reports and external statements are framed.¹³⁸ The court determined that this inference runs contrary to finding scienter.¹³⁹ The Sixth Circuit concluded that if a well-plead complaint can only allege

¹³³ Maslo, *supra* note 113, at 98.

¹³⁴ *In re Omnicare*, 769 F.3d at 476.

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *In re Omnicare*, 769 F.3d at 484.

¹³⁸ *Id.*

¹³⁹ *Id.*

that a corporation intended to defraud based on a desire to continue earning money, without showing a particular link between the actual statement and a specific payment, then the heightened pleading standard for scienter has no bite.¹⁴⁰ The Sixth Circuit's conclusion further suggests that its middle ground approach is swaying toward the narrow end of the scienter continuum. The application of the Sixth Circuit standard in *Omnicare* alludes that plaintiffs need more than what their standard indicates. Although the plaintiff seemingly met part B of the standard and scienter should have been found, it was not.

The issue in *Omnicare* and generally for corporations is that corporations compartmentalize knowledge, subdividing the elements of specific duties and operations into smaller components.¹⁴¹ The sum total of those elements constitutes the corporation's knowledge of a particular project.¹⁴² Through this technique, corporations often escape liability particularly in securities fraud actions because scienter is difficult to impute under these circumstances since it is increasingly difficult to find evidence corroborating scienter against individual agents. Ultimately, it is irrelevant whether employees administering one component of an operation know the specific activities of employees administering another aspect of the operation.¹⁴³ A corporation cannot plead innocence by asserting that the information obtained by several employees was not acquired by any one individual who then would have comprehended its full importance or effects on other parts of the business.¹⁴⁴ There must be a means to determine a when corporation acquires the collective knowledge of its employees, and in that circumstance, the corporation would be held responsible for its employees and their failure to act

¹⁴⁰ *In re Omnicare*, 769 F.3d at 484.

¹⁴¹ *United States v. Bank of New England, N.A.*, 821 F.2d 844, 856 (1st Cir. 1987)

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.*

accordingly.¹⁴⁵ While this reasoning does point toward the broader approaches to scienter, an appropriate balance between the spectrum of broad and narrow approaches and public policy underlying each one must still be achieved. For example, any positive influence the use of weak-form scienter might have on corporate policy is drastically overshadowed by its inconsistency with the federal securities laws, the inefficient incentives it creates, and its negative impact on the dissemination of information.¹⁴⁶ Yet at the same time, the strongest and narrowest approaches to scienter also run contrary to the congressional intent behind the PSLRA.

CONCLUSION

Ultimately, the Sixth Circuit standard is sufficient and better than the alternatives currently in the federal circuit courts. However, there does not appear to be that much of a distinction between the middle ground and narrow approaches when the middle ground approach is applied to scenario with sufficient facts to meet the pleading sufficiency. As a result, an appropriate balance should be struck to have an actual middle ground standard. This standard would ideally allow plaintiffs in cases such as *Omnicare* to move past the pleading stages and satisfy the scienter requirement without running against the congressional intent of the PSLRA. To combat this issue, a better standard to corporate scienter is needed because corporations are still afforded too much latitude in escaping liability in securities fraud actions through the scienter requirement. The narrow approach to scienter almost categorically favors corporate defendants and the spectrum of broad approaches run opposite to the public policy surrounding the PSLRA and Rule 9(b). Ideally, the Supreme Court will opine on this issue and create this

¹⁴⁵ *Id.*

¹⁴⁶ Paul B. Maslo, *Evaluating Approaches to Pleading Corporate Scienter: The Case for Semi-Strong Form Corporate Scienter in Securities*, 108 MICH. L. REV. 95, 99 (2011).

actual middle ground standard required to resolve the discrepancy in evaluating corporate scienter.